III. Comparison of UHF and VHF Stations

Proponents of PTAR often claim that the Rule is necessary because of the handicap faced by UHF stations relative to VHF stations. The view that the technical handicap is something that should be addressed by regulation does not lead logically to the conclusion that the Rule is an appropriate policy to compensate for the handicap. The Rule misdirects a subsidy to stations that do not suffer any technical handicap and fails to subsidize some stations that do have the technical handicap. LECG's comparison of the financial differences between independents and affiliates obscures the issue further by failing to compare like kinds of stations in a way that isolates the technical handicap. Moreover, LECG neither considers the most plausible reasons for financial differences among stations nor uses the most recently available data, both of which undermine its conclusions.

More fundamentally, even if a UHF handicap still exists, it does not justify government intervention in these markets. It cannot be too strongly emphasized that a technical UHF handicap is not, and never has been, a market failure.[32] A market failure in the broadest sense is anything that drives a wedge between prices and minimum attainable marginal social costs. Monopoly and externality are standard examples. Whatever technical signal inferiority may characterize UHF stations today, if any, is not attributable to a market failure and does not cause a market failure. To the extent that the handicap exists, it is analogous to the position of a farmer growing produce at a location that is somewhat farther from the local market than competing farmers. Neither economic efficiency nor

32 The Commission's overall spectrum allocation policies, of which the original UHF handicap was one result, may well have been economically inefficient. But given those policies, the relative technical inferiority of UHF signals was simply a technological fact, not a market failure.

fairness requires the government to tax three of the nearby farmers in order to subsidize the distant farmer. To do so is simply to engage in an inefficient form of redistribution that makes society as a whole worse off.

A. The Rule as an instrument for subsidizing independents

It is apparent that PTAR is a poor instrument for addressing any UHF handicap. The Rule is simultaneously too selective in subsidizing UHF independents as opposed to all UHF stations and too broad in subsidizing all independents as opposed to UHF independents only.

One justification given for the Rule is that UHF independents should be subsidized to offset the technical handicap they face vis-à-vis VHF stations.[33] But this ignores the fact that the technical handicap faced by UHF *affiliates* relative to VHF stations is just as substantial (or insubstantial) as that of independents. The evidence indicates that there is no offsetting financial advantage for UHF affiliates. As is discussed below, cash flow and pre-tax profits of the average ABC, CBS and NBC affiliate UHF station are lower than those of the average independent UHF station. It is not clear why a policy like PTAR, if it were designed to overcome a UHF handicap, should be restricted to UHF independents.

Even if the intent of the policy is to subsidize UHF independents, PTAR is an inappropriate instrument. PTAR benefits certain stations that are unlikely to need a subsidy and does not benefit other stations to which a subsidy may more appropriately be directed. On the one hand, the benefits afforded by the Rule extend to independent VHF stations as well as independent UHF stations. Yet these VHF stations have a higher cash flow than the average ABC, CBS or NBC affiliate in the top-50 markets.[34] On the other hand, some UHF stations broadcasting certain types of programming (*e.g.*, religious or foreign language programming) do not bene-

33 LECG, *supra* note 1 at 2–3.

34 *See* EI, *supra* note 23, Table A–12, at 74. The average VHF independent has a cash flow only slightly below that of the average affiliate in the top 25 markets, and substantially in excess of the average affiliate in markets 26–50.

fit significantly from PTAR because they do not compete for, or compete with, the type of programming that PTAR bans from network affiliates in the top-50 markets.

INTV reports that 292 independent stations operate in the top-50 markets.[35] Of these, 42 are VHF stations. The proponents of PTAR have not provided any reason why these VHF stations should be covered by a policy justified as correcting a UHF handicap. Of the remaining 250 UHF independents, 36 are affiliated with Fox and 62 are affiliated with UPN or WB. The proponents of PTAR have not provided any justification for a policy designed to correct a UHF handicap that covers UHF affiliates of these networks but not UHF affiliates of ABC, CBS and NBC. In addition, there are 106 foreign language, religious or home shopping stations. The proponents of PTAR have not provided any evidence that PTAR compensates for the UHF handicap suffered by these stations. This leaves only 46 pure UHF independents in the top-50 markets.

Finally, the Rule focuses primarily on the top-50 markets, and therefore has little if any beneficial effect on UHF stations in other markets. A policy designed to correct for any UHF handicap logically should treat all markets equally.

B. LECG's comparison of financial performance of UHF independents and network affiliates

LECG has obscured the debate about the technical disadvantages faced by UHF stations by focusing on the financial differences between all affiliates and UHF independents. LECG has paid lip service to the need to "separate out the signal quality issue from the sum total of other economic disadvantages which UHF stations may face compared to VHF stations."[36] [emphasis omitted]. When the "handicap" is put in financial

35 *Comments of the Association of Independent Television Stations*, Inc., March 7, 1995, MM Docket No. 94–123, at Exhibit 1 [hereinafter INTV]. The present data reflect correction of the errors in INTV's Exhibit 1.

36 LECG, *supra* note 1, at 32.

terms, however, it can be affected by events unrelated to the technical constraint. Any increase in competition facing UHF independents, for example, increases the financial "handicap." Nevertheless, even in terms of this unsound analysis, LECG does not demonstrate a need for the Rule.

UHF independents face competition from many sources, including VHF independents and other UHF independents. The addition of a VHF independent in a market must generally reduce the profitability of incumbent UHF independents. Part of the difference in profitability may be attributable to a technical advantage of VHF broadcasting, but some or all may be a result of the increased competition. Similarly, the addition of a UHF independent may reduce the profitability of other UHF independents because of increased competition. In this situation, LECG's analysis leads to the conclusion that the financial "handicap" has increased despite there being no change or a decline in the technical handicap.

The advent of cable poses an equally vexing problem for LECG's framework. Cable simultaneously reduced the technical handicap and increased the financial (competitive) "handicap" of UHF stations. LECG acknowledges that the spread of cable has ameliorated the technical handicap for the nearly two-thirds of television households that subscribe.[37] The impact of cable is even greater when one considers that virtually every television household (97 percent) is passed by cable and thus has access to high-quality UHF signals.[38] LECG's analysis, however, implies that the growth of cable has harmed UHF stations' financial performance. If competition from cable harms UHF independents, it is logical to conclude that cable also harms UHF affiliates. It makes no economic sense to use PTAR to subsidize UHF independents in their competition with cable while penalizing UHF affiliates who must also compete with cable networks.

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37 *Id.* at 32.

38 EI, *supra* note 23, Table A–6, at 69.

One apparent way to eliminate the financial "handicap" implied by LECG's analysis is to eliminate all competition for UHF independents. Thus, a policy of restraining Fox and the other networks in addition to retarding the growth of cable networks, such as the misguided policy the Commission pursued in the years prior to 1972, would be a far more logical response than PTAR. Even that would not be a complete solution, however, because UHF independents compete against each other, a problem that can be remedied only by an antitrust exemption.

In its Figure III.1, LECG distinguishes four stages of UHF independents' profits as a percentage of revenue: high profitability in the late 1970s, profitability in the early 1980s, sharp decline in profitability in the mid–1980s, and improved profitability in the late 1980s–early 1990s. It is likely, as LECG contends, that some of the improved profitability in the late 1970s can be attributed to PTAR, but some is also likely due to an increase in demand for advertising. It is also plausible that the increase in profits in the early 1980s could be due in part to the improvement in UHF signal quality attributable to cable.

The sharp drop in profitability in the mid–1980s, however, has many potential causes, none related to PTAR. During the mid–1980s, the number of independent stations increased dramatically. It is quite typical of businesses to incur start-up losses or low profitability in their early years of operation, particularly if initial capital investments are depreciated at accelerated rates. This would explain at least part of the depressed *average* profitability figures shown by LECG. In addition, it is likely that new stations would take audience share and thus advertising revenue in part from existing independent stations. LECG's figure shows that competition from the many new broadcast stations and cable operators appears to have harmed the affiliates' profitability as well. Also, real sales of local television advertising leveled off in 1986 after an extended period of growth.

Another factor that may have reduced overall profitability is an increase in the cost of programming caused by the growth of independent stations. This observation is also made by INTV.[39] To a large extent, independents' access-period fare is comprised of off-network programs.[40] In the short run, and to some extent over a period as long as the mid–1980s, the supply of off-network programs is relatively inelastic. Thus as more independent stations sought to show off-network programs, they bid up prices which reduced all stations' profitability, but especially that of independents.[41]

Finally, the profitability of UHF independents and Fox affiliates improved dramatically in the late 1980s and early 1990s. LECG states that this should not be interpreted as a narrowing of the profitability gap, but no other conclusion is possible. The improved financial performance of UHF independents in this period clearly is not the result of a regulatory action taken 15 to 20 years earlier and affecting one half hour on the fringe of prime time. The increase in the number of new independents slowed in the late 1980s, thus reducing the number of stations with likely start-up losses and low initial profitability. Moreover, the number of profitable stations probably increased as the new stations added in the early 1980s became established. The resulting decrease in the relative impact of new stations helped improve the profitability of UHF independents as a group. In addition, as LECG points out, the birth of new broadcast networks positively affected the profitability of UHF affiliates. The emergence of new networks can improve the profitability of all affiliates by improving the compensation package offered by the competing networks.[42] But as was discussed above, the growth of new networks in the past eight years cannot plausibly be attributed to the Rule.

The LECG data on the profitability of UHF independents show improved profitability through 1992. In fact, UHF independents were more prof-

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39 INTV, *supra* note 35, at 33.

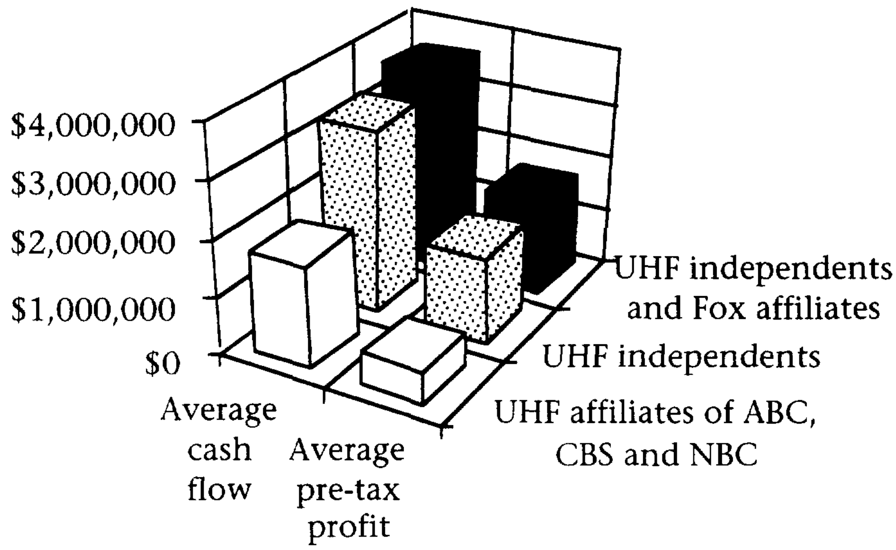
40 *Id.* at 41–42.

41 Frazier, Gross and Kadlec, *supra* note 15, at vi.

42 EI, *supra* note 23, at 15.

itable in 1992 than UHF affiliates of ABC, CBS and NBC.[43] In 1993 the profits of UHF independents continued to improve. Figure 4 shows that as a group, UHF independents (whether including or excluding Fox affiliates) had greater pre-tax profits and cash flow in 1993 than the UHF affiliates of ABC, CBS and NBC.

Figure 4 1993 Pre-tax profits and cash flow of UHF affiliates and UHF independents (with and without Fox affiliates)[44]



C. LECG econometric analysis of UHF handicap

LECG attempts to measure the UHF handicap with an econometric model that uses data for programs aired on Fox UHF and VHF affiliates at the same time in different markets. The LECG approach has deficiencies that undermine its conclusions. Even if LECG's results are accepted at face value, however, the results do not constitute strong evidence of a UHF handicap.

43 *Id.* at 76, Table A–16.

44 Source: Appendix A, Table A–3.

The most serious deficiency of the LECG analysis is its failure to use all of the data available. LECG provides no rationale for limiting its data to only one sweeps period (November 1993). In addition, LECG considers only half of the Fox prime-time programming schedule. LECG accounts for programs aired on Fox affiliates during 8–9 p.m., but not during 9–10 p.m. Even if the LECG results are taken by themselves, there is no consistent evidence of a difference in ratings attributable to the UHF handicap. In 8:30–9:00 p.m. on two different days (Monday and Thursday), the LECG results show no UHF handicap. In both time periods on Wednesday, the results show an inexplicably large UHF handicap. These shortcomings and inconsistent and mysterious results do not necessarily constitute fatal flaws in LECG's analysis, but they cast serious doubt on its validity.

D. Summary

The Rule was not intended to provide protection to UHF stations that were disadvantaged because of technical considerations, and it is a poor instrument for providing that protection in any event. LECG's comparison of the financial performance of UHF independents with network affiliates fails to shed any light on the merits of PTAR. Changes in the financial condition of UHF independents can readily be attributed to factors unrelated to the Rule. The current strong financial condition of UHF independents indicates no need for further subsidy at the expense of viewers, advertisers and network affiliates. LECG's econometric model of the UHF handicap of Fox stations provides little additional useful information because it fails to include all available information and produces inconsistent results.

IV. Impact on the Syndicated Programming Market

Another important theme in LECG's analysis is that there exists a systematic bias in competition between first-run and off-network syndication programming. This so-called bias, LECG claims, requires a "corrective rule" like PTAR. Discussion of a corrective rule implies that a market failure exists, but LECG never identifies a market failure. Though LECG refers to a "public goods" problem in syndicated programming, LECG does not pursue that framework as a basis for a regulatory corrective action like PTAR.

According to LECG, "off-network programs are a serious threat to push first run programs out of the access period on network affiliates, even when first run programs are more popular with viewers."[45] Once again, LECG implies that certain consequences of removing the Rule (substitution of off-network for first-run syndicated programming) are undesirable, yet never identifies a market failure that produces this result and thus needs to be corrected. LECG's own analysis of the market does not demonstrate a bias leading to inefficient market outcomes. The purportedly nefarious aspects of competition between first-run and off-network programming stem from normal operation of the market. For example, programs with various levels of popularity are provided in the market. Also, there are short-run and long-run costs that must be covered by any programmer, syndicated or otherwise, in order to stay in business. What keeps this market from operating normally and produces any bias is that PTAR forces network affiliates to air first-run syndicated programs when they may prefer first-run network or off-network programs. If first-run syndicated programming were hurt as a result of a repeal of PTAR, it would be because repeal strengthened competition among programs, not because of a flaw in the market.

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45 LECG, *supra* note 1, at 81.

A. Public good nature of broadcasting

Advocates of retaining PTAR periodically touch on the benefits of regulation of a public good. But both INTV and LECG fail to pursue the public good framework—an indication of the inconsistent positions each maintains with regard to this issue. INTV states that "broadcasting is a public good for which regulation often is necessary...."[46] LECG views "PTAR as a corrective for a failure in a public goods market, namely the market for syndicated programming."[47] Although they condemn PTAR, Owen and Wildman concur that "[t]he product sold in the video industry is a public good—that is, one with high fixed costs and low marginal costs."[48]

It is nonsense to say that PTAR addresses the problem of the public good nature of video programming. Public goods are normally thought of as being underproduced in a competitive market because pricing them at marginal cost to the marginal consumer may not allow the producer to earn a competitive rate of return. Particularly where programming is supported by advertiser rather than viewer payments, there is likely to be too little video programming produced. *This holds true for video programming of all types, not just first-run syndicated programs.* In effect, the Rule subsidizes the production of first-run syndicated programming, thus mitigating possible underproduction of that sort of programming. The subsidy, however, comes at the expense of network programming and off-network syndicated programming, *both of which are also video programming public goods.* The Rule simply does not address the market failure that may be associated with the public good nature of video programming. Rather it subsidizes one type of public good and penalizes another. This is like addressing the poverty problem by giving aid to poor people with names beginning with the letters A-M while raising the money by taxing poor people with names beginning with N-Z.

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46 INTV, *supra* note 35, at 9.

47 LECG, *supra* note 1, at 4.

48 OWEN & WILDMAN, *supra* note 10, at 25.

In fact, PTAR worsens the video programming public good problem by interfering with network efficiencies. A product like video programming with public good characteristics can be produced by competitive markets. As Owen and Wildman state, "[t]o be profitable, business strategies for selling public goods must repeatedly exploit each product. Competitive advantage lies in reaching the largest audience for each product and in exposing the product in as many different markets as possible."[49] This is done for network programming by airing the programs over a large number of affiliates and then syndicating them as off-network programs. This reduces the cost per viewer, and therein lie network efficiencies. PTAR undermines network efficiencies by foreclosing one of the distribution windows. The effect of restricted distribution on the quality of network programming is similar to the effect of foreign trade barriers imposed by certain countries on U.S. films and programs. As (LECG co-author) Wildman and Siwek point out, "producers may respond to lowered potential earnings on films by producing fewer and less expensive films.... Earnings from traded films and programs will therefore decline even further due to reduced quality and output."[50] PTAR reduces the quality of network prime-time programs and thus imposes a cost on all viewers of network prime-time programming.

In sum, while it is correct that video programming is a public good, it is incorrect that PTAR has any role to play in resolving the issues associated with public goods. PTAR simply promotes one type of video programming at the expense of others and limits the network efficiencies that make production of public goods feasible in a competitive market.

B. The "handicap" of first-run syndicated programming

LECG is concerned that elimination of the Rule will result in "more popular" first-run syndicated programming being replaced with "less popular" off-network programming. According to LECG this will occur because

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49 *Id.*

50 STEVEN S. WILDMAN AND STEPHEN E. SIWEK, INTERNATIONAL TRADE IN FILMS AND TELEVISION PROGRAMS (1988) 9–10.

first-run programming faces a handicap: it must recover all of its production cost from the syndication market, whereas off-network programs have already recovered a large fraction of their costs from ABC, CBS or NBC. There are four problems with LECG's arguments.

First, the empirical basis for this claim is exceptionally weak. Based on LECG's own data the average off-network syndicated program has *unrecovered* production costs of around $90,000 per episode.[51] This is comparable to the per-episode production costs of the average first-run syndicated program, which LECG estimates at $70,000 to $100,000 per episode.[52]

Second, replacement of first-run by off-network series, even if it occurs, does not reflect a market failure. A market economy is replete with examples of goods that do not get produced because the revenue they generate does not cover the cost. Indeed, the practice of releasing programs in a series of windows (such as network followed by syndication) is one way, according to Owen and Wildman, in which the public good nature of programming is addressed.[53] It would be standing current understanding on its head to argue that there is any market failure or unfairness inherent in the success of such programming at the expense of programming that does not have sufficient enduring value to take advantage of the economies of windowing.[54]

Third, LECG's concern appears to reflect a misunderstanding of how the program supply market operates. The success of first-run game and talk shows in competing with off-network programs in the access period lies

51 LECG, *supra* note 1, at 64 and 71.

52 Id. at 71.

53 OWEN & WILDMAN, *supra* note 10, at 25.

54 First-run syndicated programming that has such value, such as *Star Trek—The Next Generation,* does take advantage of windowing by repeated releases in syndication.

not in greater popularity but in lower production cost.[55] Broadcasters are concerned with cost per rating point. First-run syndicators compete successfully with off-network programs when they offer programs whose low cost offsets their relatively low ratings. In equilibrium, the supply of off-network and first-run syndicated programs should adjust so that marginal programs of each type cost the same per rating point.

Fourth, LECG has provided no sound empirical basis for the proposition that first-run programming is more popular than off-network programming.[56] LECG compared ratings for such programs in a small number of markets (markets 51-60), but made no attempt to correct for such crucial factors as network affiliation of the stations broadcasting the programs. Because off-network programs tend to be broadcast by independents and first-run programs by network affiliates, it is likely that something other than the inherent popularity of the programs is being measured.

The network programming restriction in the access period *reduces* the quality of options available to viewers. Further, the off-network restriction reduces the quality of options available to ABC, CBS and NBC affiliates and viewers. If network affiliates were free to choose off-network programming in the access period, the quality of network programming would ultimately increase, a result that stems from the public good nature of all video programming. Removing a constraint such as PTAR that artificially suppresses demand for a product will increase demand for that product. LECG's analysis supports the conclusion that elimination of the Rule would result in an increase in demand for off-network program-

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55 LECG, *supra* note 1, at 71, masks this difference by comparing the cost of five weekly episodes of a first-run series with the cost of one weekly episode of a first-run network series.

56 Nor is there any theoretical basis for this conclusion. Off-network programs are produced at greater cost and with higher production values than first-run programs. Further, they generally have been heavily promoted during their network runs. Other things equal, one would expect them to be more attractive to viewers than first-run syndicated programs that lack these characteristics. Of course, some viewers may prefer not to see episodes they have seen before. But other viewers may prefer to see favorite episodes again. There is no *a priori* basis to assign viewer willingness-to-pay estimates to the two types.

ming. Thus, LECG's claims about the relative popularity of current first-run and off-network programs, in addition to being statistically flawed, are based on a false premise: that in a world without PTAR, off-network programs would not in the long run have higher production values and therefore increased popularity.

As noted above, the supply of recent off-network programming is inelastic in the short run. To the extent that demand for off-network programming increases and supply is inelastic, the price paid for off-network programming will increase. An INTV survey indicates that removal of PTAR would lead to an increase in the price of off-network programming by as much as 40 percent.[57] An increase in the price of off-network programming would likely lead to an increase in the quality of first-run network programming. In anticipation of the increased revenue if a network program goes into syndication, producers will increase expenditures on network programs and produce programs of higher quality. Viewers of prime-time programming will benefit from this increase in quality, as will subsequent viewers of off-network programming.

LECG's claim that "the substitution of less popular off-network programs for the first run programs viewers like better...is not in the best interest of viewers"[58] is based on assertions and unsupported statements. As Owen and Wildman state, "[t]he prime-time access rule...works against viewers' interests."[59] Given the public good nature of television programs, there is no reason to believe that social welfare is improved by banning off-network programs from certain distribution windows. Even if off-network programming were less popular, it may be efficient for the market to deliver such programs in the access period. As noted above, ratings do not necessarily reflect consumer or social welfare. Without information about viewers' preferences and the relative costs of programming, LECG's claims of harm to viewers amount to little more than speculation.

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57 INTV, *supra* note 35, at 51.

58 LECG, *supra* note 1, at 83.

59 OWEN & WILDMAN, *supra* note 10, at 180.

The primary basis for LECG's claim that there is a bias against first-run programs in competition with off-network programs is its claim that off-network programs need only cover distribution costs while first-run programs must cover full costs. This ignores how off-network programming is produced and the importance of long-run costs. Off-network programming is "jointly produced" with first-run network programming. As a joint product with first-run network programming, off-network programming simply has a different cost structure than first-run syndicated programming. This is not a failure of the market, but merely different features of these products. At the most general level, first-run programming tends to be lost-cost, low-quality fare, while programming originally produced for networks tends to be high-production-cost, high-quality fare. The two compete "fairly" at the margin where cost-per-rating point is equalized. In the competition between first-run syndicated and off-network programming, off-network has the advantage of having higher production values and advance promotional efforts; first-run has the advantage of not having been seen previously by the potential audience.

LECG notes, but seemingly ignores, the importance of long-run costs of network and syndication producers. "Survival in the long run requires that both types of producers make substantial up-front investments in the development of new programs, the ultimate success of which is highly uncertain for any particular program.... Ultimately, revenues realized by [network and syndication] suppliers must be sufficient to cover the up-front costs of both successful and unsuccessful programs plus the production costs of episodes created."[60] All producers operate under the same constraints. This hardly constitutes a bias against one type of producer.

Similarly, all purchasers—affiliates and independents—face the same costs of using off-network programming. Regardless of whether the cost difference between first-run and off-network syndicated programming is a normal aspect of competition or reflects some failure of the programming market, there is no reason why the affiliates of ABC, CBS and NBC alone

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60 LECG, *supra* note 1, at 64.

should bear the cost of a policy that favors first-run syndicated programming. Independent stations, which are free to choose off-network or first-run syndicated programming, predominantly choose the former.[61]

Likewise, network affiliates should not be forced to shoulder the burden of a policy that promotes first-run syndicated programming by being compelled to take on more risk than they would in a competitive market. According to LECG, first-run syndicated programming is inherently more risky than off-network programming. LECG concludes from observing the sequence in which large-market and small-market affiliates sign on to a first-run syndicated program that these programs must be tested first in a larger market before smaller-market affiliates will chose them. It is difficult to see how this distinguishes first-run from off-network series. LECG does not explain why the market would not be able to allocate an optimal amount of more risky (first-run syndicated) programs and less risky (off-network) programs in the different markets without the influence of the Rule.

Moreover, LECG evidently assumes that the Rule is necessary to the success of first-run syndicated programming because the Rule forces large-market affiliates to air first-run shows; this enables their distributors to expand to the smaller markets. This assumption ignores the possibility that first-run shows sell first in large markets simply because initial sales efforts are focused there in order to secure a large enough potential audience to sell national advertising. Without the Rule, LECG argues, affiliates in the larger markets would change their programming choices and affiliates in the smaller markets would follow. LECG fails to note that virtually all contracting for first-run syndicated programming occurs before the shows are aired. Further, there is no reason why independent stations cannot serve as the first-movers in larger markets for first-run syndicated programming.

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61 INTV, *supra* note 35, at 42.

C. Summary

Despite the claims of LECG, it is doubtful that the Rule was ever needed for the survival of first-run syndicated programming.[62] The Rule probably provided a modest contribution to the growth of first-run syndicated programming, but there is no evidence that first-run program production will collapse in the absence of the Rule. First-run programming has established itself against network programming in prime time.[63] In addition, an INTV survey indicates that independent stations that lose access to off-network programming will switch to first-run syndicated programming.[64] There is no basis for continued subsidization of a thriving sector of the video programming industry.

A closer examination of LECG's analysis reveals no support for the existence of a bias or market failure in the competition between first-run and off-network syndicated programming that would justify retention of the Rule. The public good nature of video production is not a valid basis for a policy like PTAR. To the contrary, PTAR may actually thwart the competitive market's attempt to produce public goods efficiently. The quality differences among different types of programming do not necessarily lessen viewer welfare and are exacerbated by PTAR. LECG's lengthy analysis of cost differences between first-run and off-network syndicated programming is of no consequence as it simply describes competition among products with different characteristics.

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62 THOMAS G. KRATTENMAKER & LUCAS POWE, JR., REGULATING BROADCAST PROGRAMMING 72–73, 287, 290 (1994).

63 INTV, *supra* note 35, at 59. See also *Syndication in the 1990s*, ELECTRONIC MEDIA, at A–5, April 10, 1995, "In point of fact, syndication's top shows are able to compete head-to-head with the best of Network television."

64 INTV, *supra* note 35, Exhibit 7.

V. ABC, CBS AND NBC DO NOT DOMINATE VIEWING AND ADVERTISING MARKETS

LECG clings to the discredited argument that ABC, CBS and NBC dominate the viewing and advertising markets. The intensity of competition among the original broadcast networks and their rapidly declining market shares render this argument palpably false. LECG's focus on an advertising market is doubly curious. First, PTAR is not, and never has been, intended to rectify any problems in the advertising market. Second, LECG's definition of the relevant advertising market is methodologically groundless and even contradicted by one of the LECG co-authors. LECG fails to discuss the most plausible reason for an increase in network advertising rates—increased demand for advertising—and focuses instead on an implausible market-dominance argument.

A. The viewing "market"[65]

There is no doubt that the prime-time market shares of ABC, CBS and NBC separately and combined have fallen dramatically since 1980. This does not make for network domination of the viewing market. Even before the viewing shares fell, the long-running competition among the networks for prime-time audience could not be called anything less than intense. The decline in shares has increased the intensity of competition in the market and made it even less plausible that the three rival networks could dominate the prime-time viewing market.

The decline in audience share held by ABC, CBS and NBC has been caused by a number of factors. Chief among these is the steady increase

65 The concepts of viewing and advertising markets are used here as tools for discussing LECG's analysis. None of the "markets" discussed necessarily denotes properly-defined antitrust product markets.

in cable penetration such that in 1994, nearly 97 percent of television households had access to cable and 62 percent subscribed. In addition, the number of independent and low-power stations has increased rapidly since 1980. The availability of video programming through other means, such as backyard satellite dishes and emerging direct broadcast satellite systems, has diminished network audience shares and will exact an even greater toll in the future.[66]

Not only are ABC, CBS and NBC unable to dominate the "market" for prime-time viewing, they are insignificant producers of video programming. Even their purchases account for only a small portion of first-run video programming.[67]

Interestingly, LECG points to HHIs as indicating that viewing markets during prime time (including the access period) are "moderately concentrated," but then boasts that "there is no evidence to support a finding of market power" on the part of Fox, King World and Viacom/Paramount during the access period.[68] LECG's Table II.4 shows the market shares of these program distributors for the access period, but fails to calculate an HHI as was done on the tables for prime time as a whole. The HHI for the total.audience in the access period, however, is 1,937 which is considered "highly concentrated" under the DOJ/FTC *Merger Guidelines*. This point is raised not because the access period should be considered a relevant market, but because LECG evidently views an HHI over 1,900 as not constituting evidence of market power. Thus the HHIs shown in Tables II.1 and II.2 for all of prime time, which range from 1,313 to 1,540, cannot support a finding of market power under LECG's framework.

B. The advertising market

Defining any particular advertising market is largely irrelevant to a discussion of PTAR. The Rule was never intended to address the structure or

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66 EI, *supra* note 23, at 69, Table A–6.

67 *Id.* at 24–25.

68 LECG, *supra* note 1, at 16.

performance of any advertising market. The FCC believed that PTAR would increase the level of competition in the independent production of programs, reduce the networks' control over their affiliates' programming decisions and increase the diversity of programs available to the public.[69] As Owen and Wildman state in *Video Economics,* "the purpose of the prime-time access rule...was to give other program producers access to individual station broadcast time through the first-run program syndication market."[70] None of these purposes is related directly to the structure or performance of the advertising market.

Even under the mistaken notion that advertising is an appropriate focus for evaluating the Rule, LECG fails to adhere to a sound methodology for defining an advertising market. A comparison of advertising rates and changes in rates is inadequate evidence for defining a market. The existence of a price premium does not mean, as LECG implies, that the lower-priced product is not in the same market as the higher-priced product. Simply because advertisers are willing to pay more for prime-time television audiences does not mean that advertising in other time periods, and indeed other media, does not discipline the prices of prime-time advertising. Advertisers make trade-offs among the cost of the advertisement, the size of the audience reached, duplication of audience and the audience's demographic characteristics.

The proper approach to market definition is to consider the extent of substitution among products. Insofar as the availability of one good forces producers of another to price competitively, both are in the market. The 1992 *Merger Guidelines* of the Department of Justice and the Federal Trade Commission focuses on exactly this issue in defining a market. "A price increase [by a hypothetical monopolist] could be made unprofitable by consumers either switching to other products or switching to the same product produced by firms at other locations. The nature and

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69 FCC, Notice of Proposed Rule Making, MM Docket No. 94–123, Released Oct. 25, 1994, ¶1.

70 OWEN & WILDMAN, *supra* note 10, at 179.

magnitude of these two types of demand responses respectively determine the scope of the product market and the geographic market."[71]

Following the *Merger Guidelines* approach, it is clear that at least national spot advertising is in the same market as national network advertising. National spot advertising is an available substitute for network advertising.[72] As Owen and Wildman point out, "spot and network prices are interdependent. Increases in the price of network advertising affect advertisers' allocations of budgets between network and spot."[73] They further state that "network sales and national spot sales are best regarded as differentiated products in the same market."[74]

LECG argues that cable advertising is not in the same market as network advertising and fails to take into account the importance of advertising in other media.[75] Owen and Wildman state, however, that "there are a number of more or less good substitutes for network advertising: spot television advertising, advertising on basic cable networks and superstations, network and spot radio, national magazines, direct mail, billboards and newspapers."[76] A study by the FCC found that spot television, radio, magazine, newspaper and outdoor advertising discipline network advertising rates, leading the networks to charge advertising rates that reflect competitive forces.[77]

National market sales of television advertising by syndication distributors has grown dramatically since 1980, as LECG's Figure II.4 shows. Total syndicated advertising sales are still well below those of the networks but

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71 Department of Justice / Federal Trade Commission, *Horizontal Merger Guidelines*, 1992, §1.0.

72 EI, *supra* note 23, at 20.

73 OWEN & WILDMAN, *supra* note 10, at 157.

74 *Id.* at 13.

75 LECG, *supra* note 1, at 30–31.

76 OWEN & WILDMAN, *supra* note 10, at 154.

77 FCC, NETWORK INQUIRY SPECIAL STAFF, THE MARKET FOR TELEVISION ADVERTISING, PRELIMINARY REPORT (1980).

contrary to LECG's assertion, that does not undermine the competitive influence of advertising on syndicated programs. LECG implicitly acknowledges the price-disciplining effect of barter-syndicated advertising by including it in the market with network advertising. Any attempt by ABC, CBS and NBC cooperatively to raise advertising rates could be made unprofitable by a relatively small portion of total advertising sales shifting to syndication distributors. It is not necessary that all advertising sales shift to syndicators, just enough to cause the profit gains from an increase in rates to be offset by the losses from a reduction in sales.

Even using its own faulty narrowly-defined national-network advertising market, LECG is unable to demonstrate that ABC, CBS and NBC possess market power. LECG asserts that the increase in CPM rates for prime-time network advertising during the 1980s is evidence of market power on the part of ABC, CBS and NBC. LECG fails to prove this assertion, however, merely stating that one should not expect network prime-time advertising rates to rise faster than consumer prices given the increased competition faced by the networks in the 1980s. LECG's assertions simply are not grounded on solid economic analysis. LECG has not considered, nor even mentioned, other more likely causes of increased advertising rates.

The most plausible reason for increased prime-time network advertising rates is that growth in the demand for advertising temporarily outstripped supply. With a limited supply of television advertising hours, it is not surprising that a short-term increase in demand will result in an increase in rates. LECG acknowledges that advertising rates decline during recessions.[78] Logically then, the increase in the demand for advertising resulting from the economic expansion of the 1980s, combined with the limited (or more slowly growing) supply of advertising time, is sufficient to explain increased rates. Network advertising CPM rates track closely the rapid economic growth during 1983–1990. The slowdown in economic growth in the 1990s resulted in reduced prime-time network advertising rates. As Figure 5 shows, real prime-time network advertising

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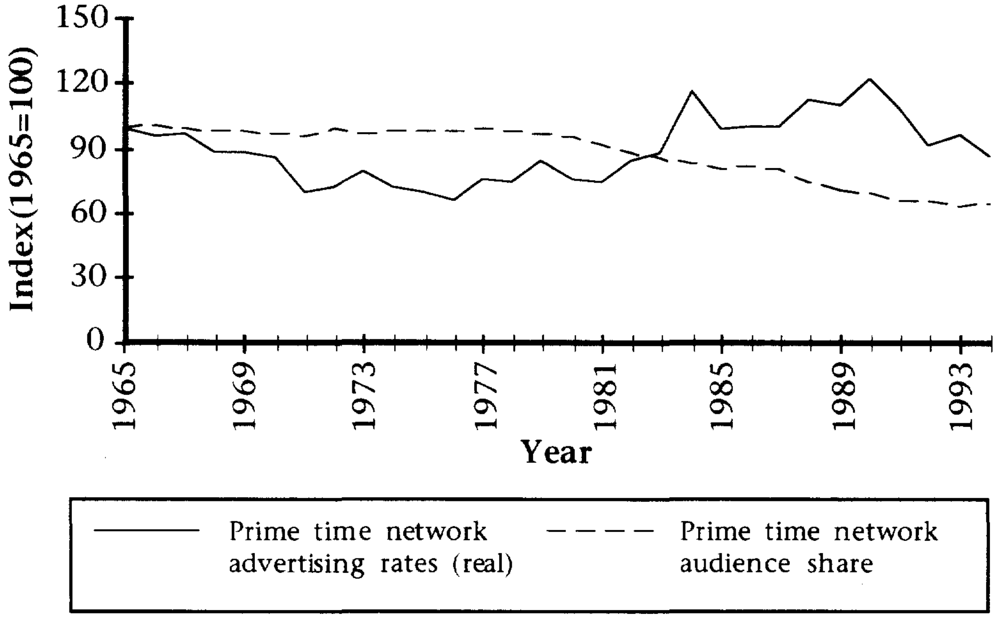
78 LECG, *supra* note 1, at 27.

rates have held relatively stable since 1992 at the lowest level since the early 1980s and lower than they were in the mid–1960s.

Figure 5 Real prime-time network advertising rates and audience share, 1965-94[79]



If, as LECG claims, ABC, CBS and NBC have market power in the 1990s with market shares between 17 and 23 percent each, they must certainly have had market power in the late 1960s with market shares averaging more than 30 percent. Real advertising rates declined in the late 1960s when the networks market shares were much higher. It makes no sense that ABC, CBS and NBC would use their alleged market power to raise rates in the later period, when their shares were far smaller, but not in the earlier period.

LECG claims that removing PTAR will make it harder for new networks to compete against ABC, CBS and NBC in providing national advertising.[80] The removal of any regulation that, like PTAR, disadvantages ABC, CBS and NBC affiliates would have the same effect. LECG has shown no mar-

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79 Source: Appendix A, Table A–4.

80 LECG, *supra* note 1, at 88–95.

ket failure, market power or other economic reason for regulation to facilitate entry into the national advertising business, especially by penalizing incumbents. In any case, PTAR never was needed to facilitate the entry of new networks and has not materially affected the emergence of new networks.

The evidence demonstrates clearly that ABC, CBS and NBC do not dominate the market either individually or in sum. The networks compete intensely among themselves and with other video and non-video media for audience and advertisers. LECG's misguided attempt to define an excessively narrow national network advertising market is at odds with reality and the previous conclusions of one of its own authors. The increase in advertising rates that it attributes to dominance of the networks can more plausibly be explained by increased demand for advertising, a position consistent with LECG's own statements and with economic theory.

VI. Effects on Local Advertising and Programming

LECG claims that eliminating the Rule would have two detrimental local effects: a reduction in the amount of local advertising and a reduction in the amount of local programming. As was discussed above, LECG does not provide a convincing argument as to why, even if its assertions regarding local effects are true, a reduction in the amount of local advertising and programming is not the efficient outcome of a competitive market. Although the Rule was intended to promote local programming, it did not address a market failure related to local advertising and programming.

According to LECG, PTAR had a dramatic impact on local advertising starting in 1975. LECG shows spot local sales of television advertising in nominal dollars and alleges a break in the trend in 1975.[81] LECG's graphical depiction obscures the steady growth of spot local television advertising through the 1960s, well before PTAR was enacted. As Figure 6 shows, growth in real local advertising expenditures slowed during the recession of the mid-1970s, picked up again in 1976–78 and leveled off again through the economic downturns in 1979–82.

LECG points to the growth in nominal local television advertising expenditures starting in 1976 and attributes it to PTAR taking full effect in the fall of 1975. LECG does not explain why it took over four years for the Rule to have this effect. In addition, it does not consider other factors that likely affected the growth of local television advertising.

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81 *See* LECG, *supra* note 1, at 87.